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County-Assessed Properties Division
State Board of Equalization

Corporate Tax

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April 30, 2008

David J. Gau
Deputy Director
Property and Special Taxes Department
State Board of Equalization
450 N Street
P.O. Box 942879
Sacramento, California 94279-0064

Dear Mr. Gau:

This letter will contain some brief comments related to the Discussion Paper accompanying your letter dated February 20, 2008. This letter is submitted by Qwest Communications Company ("QCC"), which operates a long-haul, inter-exchange business in the State of California.

We begin by observing that QCC is probably one of the smaller state-assessed telecommunications companies. We encourage the staff and the Board to consider how comments made by other taxpayers, specifically larger telecommunications companies, might be applicable to smaller telecommunications companies.

The focus in this letter will be on four issues reviewed in the Discussion Paper that have particular relevance for Qwest. These issues relate to the items listed beginning near the bottom of page 7 of the Discussion Paper, where the staff identifies concerns with various obsolescence approaches that have been presented to them over the last few years.

Our first comment relates to the first of these items where the staff discusses issues related to the method of comparing investment returns for the subject property with returns of companies having similar characteristics. The Paper states that this is not a reliable method to determine value of the tangible property "as a separate group," and that there is more to a business than just the tangible property: "Other factors can contribute positively or negatively to the business, such as, labor, management, and intangibles, including trade names, franchises, contracts, etc." Although the Paper makes a valid point in noting that a simple income/return analysis may overlook other factors that contribute to the performance of the company, the failure to account for these factors should simply cause an understatement of the amount of obsolescence. For instance, assume that a company earns a total return of $80 million on assets that have a net book value of $1 billion, which does not reflect unbooked intangibles. The market-required rate of return is 10%, so there is indicated obsolescence of 20%. Assume further that you could determine that $20 million of that $80 million return was attributable to the unbooked intangibles, so that only $60 million was attributable to the tangible assets. The return on the tangible assets would then be only 6% and the indicated obsolescence would be 40%. Thus, if the appraiser tried to consider the effect of intangibles on the performance of the company, it would only cause the measurement of obsolescence to increase.

Our second comment concerns item 3 in the issues addressed in the Discussion Paper, on page 8. That paragraph states that "the amount of additional obsolescence to be recognized would not be as material after a company has taken a <u>recent</u> FASB 144 impairment as part of its financial statement reporting or after an FASB 141 purchase price allocation adjustment." It should be noted that there is no relationship between the test for measuring impairment pursuant to FASB 144 for financial accounting purposes and the test for measuring economic obsolescence for determining fair market value for property appraisal purposes. However, we don't necessarily disagree that when a write-down for financial accounting purposes has occurred within a year or even two prior to the assessment, the taxing authority may have a stronger case for resisting further obsolescence adjustments. However, when it is longer than that, the relevance of a write-down is extremely diminished. This industry is dynamic and constantly changing, and the rate of change appears to be increasing all the time. Not only is technology continuing to change, but so is the competition. Since 2002, when QCC wrote-down the value of its assets, there have been a number of mergers and acquisitions, where the justification for the merger always includes synergies that will make the combined company more competitive with companies like QCC. Similarly, since 2002, several companies have been through bankruptcy proceedings and have successfully emerged with lower cost structures and an enhanced ability to compete against companies like QCC.

Our third comment also indirectly addresses the write-down issue. The argument has been made, for QCC and probably other telecommunications taxpayers, that the company would not have made investments since the write-down unless the new investments satisfied the capital budgeting criteria of earning a fair return. In other words, after starting from a "clean slate" after the write-down, why would a company make new investments that might earn inadequate returns? The argument concludes that because the write-down took care of the older assets, and since the new assets must have met investment bench-marks, there is no basis for an obsolescence deduction.

There are several problems with this conclusion. The problem with assuming that old write-downs resolve problems with old assets has already been addressed; it has now been 6 years since QCC had its write-downs. With respect to new investments, management is always optimistic about earning the cost of capital on its new investments, but that is not always the reality. More importantly, these arguments misconceive the nature of the capital budgeting process in a complex operation. Many if not most investments in such a business are made with no specific return-on-investment analysis. If a $10 million switch, for instance, needs to be replaced, and the switch is part of an integrated set of assets that earns $50 million per year, it is not necessary to perform a return-on-investment analysis to decide to make that purchase. Even if the company as a whole is earning a 0% return overall on its invested plant, and even though this investment will not produce any additional revenue, it is prudent to make the investment to protect the value of the overall operation. Not making the investment would cost the company $50 million per year, so making the investment generates a huge incremental return on a "with or without" basis, but with no additional return to the company.

A related analysis affects investment in new technology. A company may be faced with the decision to make new investments to retain existing customers or maintain its market share, even though the new investments will not result in any additional revenue. Both of these examples help explain to the skeptic why a company like QCC would make new investments after the write-down, but would not necessarily have the expectation that those new investments are going to earn new returns that would justify the investment from a capital budgeting standpoint.

Our fourth comment relates to the issue identified in the Discussion Paper as item 7, on pages 7-8. Here, the staff notes its concerns with the inutility method of measuring obsolescence. The staff notes that this method requires some estimate of "theoretical or practical capacity versus actual production," and that "Determining accurate practical capacity and actual production levels for telecommunication properties can be difficult". QCC believes these positions overstate the difficulty of applying this method, and overlook a simplifying assumption.

First, we do not see why it is difficult to determine the actual production levels. The actual production is a known number that should be easily observed from the company's records. Second, the practical capacity should also not be difficult to determine, based on engineering or design standards or criteria. In addition, there is a simpler method that can be applied if the taxpayer is willing to do so. Any question of the optimum or target capacity of a set of assets can be resolved by recognizing that the optimum production level cannot be less than what has been achieved by these or similar assets during their useful lives. For example, assume there is a dispute about whether an optimum capacity level is 90% or 80% of total capacity. If the business at one time was able to operate at 75% capacity and is now at 50%, then the minimum inutility adjustment would be one-third ((75-50)/75). A taxpayer's concession to use the maximum <u>achieved</u> capacity would take this issue off the table altogether.

QCC can provide evidence of its maximum capacity on representative segments of its plant. Such a bench-mark should set a minimum level of obsolescence based on the inutility method of measurement.

We appreciate the opportunity to provide these comments to you. If you should have any questions, please contact me.

Sincerely,

Nancy Riedel

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